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C O N F I D E N T I A L SECTION 01 OF 04 BAKU 001247

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DEPT FOR EUR DAS MATTHEW BRYZA AND H MARIA TREJO

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SUBJECT: CHAIRMAN LUGAR AND ENERGY EXECUTIVES DISCUSS AZERBAIJAN'S GROWING ROLE AS REGIONAL ENERGY PROVIDER

Classified By: AMBASSADOR ANNE E. DERSE, PER REASONS 1.5 (B, D).

**¶11. (C) SUMMARY:** Chairman Lugar held a breakfast roundtable with international energy executives August 21 to discuss Azerbaijan's growing role as an international energy provider, the challenges facing the country as oil revenues increase and the GOAJ grapples with sustainable development. The executives told Senator Lugar that Azerbaijan needed to begin reforming the economy and the country now before the effects of its oil wealth overwhelm the government. The executives noted that the Government of Azerbaijan needed to implement reforms to combat corruption, reform the tax system, improve education, reform the judicial sector and increase economic cooperation with its Caspian neighbors. Lugar briefed the executives on his recent trip to Kazakhstan, remarking that Kazakhstan's successes could serve as a model for Azerbaijan. Lugar and the executives agreed that based on Azerbaijan's geographic location, between Russia and Iran, political stability and good relations with the West were key to its further development. Calling Azerbaijan a "success story," Lugar stated that the GOAJ needed to ensure that all Azerbaijani citizens see the benefit of the country's oil wealth. He said he was prepared to raise this issue with President Aliyev. END SUMMARY.

**¶12. (C)** At a breakfast roundtable August 21 with international energy executives operating in Azerbaijan and other Caspian countries, Chairman Lugar, accompanied by Ambassador and senior staff in the Codel, heard a wide variety of opinions on the future of Azerbaijan's role in global energy politics and the numerous challenges facing the country, most significantly fighting corruption. The companies at the breakfast included BP, ExxonMobil, Halliburton, Statoil, and McDermott. The group told Senator Lugar that there were five areas in which the GOAJ needed to be pushed: fighting corruption, reforming the tax system, reforming the education system, reforming the judicial sector and increasing cooperation with its Caspian neighbors. All of these elements represent major impediments to equitable and effective use of Azerbaijan's growing wealth and the country's stature as a regional and international energy player.

BTC OPERATIONS AND RELATIONS WITH KAZAKHSTAN

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**¶13. (C)** Senator Lugar opened the discussion by briefing on his recent visit to Kazakhstan, noting that Kazakhstan's biggest challenge was finding viable export routes for its oil. Lugar also noted that the Government of Kazakhstan was

interested in trans-Caspian oil and gas pipelines but understood that both Russia and Iran would object. Lugar indicated that based on his discussions, a trans-Caspian pipeline seems technically feasible but would require immense political will. AIOC President and BP executive David Woodward added that in the short-term several oil companies (including ChevronTexaco) were already exporting crude from Kazakhstan across the Caspian via tanker ship to the BTC pipeline in Azerbaijan. These crude shipments, however, would grow much larger by 2009-2010, making a trans-Caspian pipeline more valuable.

¶ 14. (C) Woodward told Senator Lugar that the recently completed Baku-Tbilisi-Ceyhan pipeline was currently delivering 530,000 barrels of oil and this total would slowly increase over time. Woodward said that most of the Azerbaijani crude loaded at Ceyhan was headed to Mediterranean destinations, although in the medium-term more crude could head to the United States. Asian countries, including India and China, may also be viable destinations for Azerbaijani crude. Woodward noted that the ACG Production Sharing Agreement currently ends in 2024 although it can be extended for five years. BP and AIOC will begin negotiating an extension of the ACG PSA with the GOAJ and SOCAR, although the outcome of these discussions remained unclear.

¶ 15. (C) Woodward noted that Shah Deniz Phase I would begin pumping natural gas this fall and that AIOC was exploring additional wells for Phase II. He briefed on the pipeline construction problems in Turkey and with BOTAS, noting that Turkey may not be ready to take some of Phase I gas, leaving it for Azerbaijan. (We understand that President Aliyev, PM

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Erdogan and President Saakashvili agreed in Istanbul in July that 20 percent of Turkey's share will be sold to Georgia.) Negotiations between the two countries are reportedly underway.) He noted that Kazakh gas could be sent via pipeline to Azerbaijan around 2012 but that most of the gas was associated with that country's oil production and is not as "clean" as Azerbaijani gas.

#### OIL REVENUE MANAGEMENT

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¶ 16. (C) Senator Lugar remarked on the booming construction sector in Baku and the tremendous oil revenues facing the Government of Azerbaijan. Following up on his visit to Kazakhstan, Lugar asked the group whether Kazakhstan could be a model for Azerbaijan, noting its strong banking sector and successful management of gas and oil revenues. Lugar noted that Kazakhstan, like Azerbaijan, had been criticized for placing too much money in the construction sector, that its development of Astana was well planned and that the President of Kazakhstan was raising the standard of living for the general population. Azerbaijan needed to do the same for its population.

¶ 17. (C) Woodward noted that Azerbaijan had successfully implemented its State Oil Fund to control and sterilize the oil revenues coming into the economy from the energy sector. In addition, he stated that the GOAJ's recent appointments of more Western, forward-leaning economic decision-makers, such as Finance Minister Sharifov, were a positive move. Woodward quickly noted, however, that corruption was a serious problem in Azerbaijan; it is getting worse and is hurting the economy.

#### FIGHTING CORRUPTION KEY TO IMPROVING

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¶ 18. (C) Woodward stated that many in the GOAJ have their own personal interests embedded in the economy, linking the problem of money laundering to the booming construction sector. Woodward lamented that the GOAJ has not taken any real steps to fight corruption, liberalize the economy and

strengthen the banking sector, casting doubt on whether the benefits from the oil wealth will reach all Azerbaijani citizens.

¶19. (C) One energy executive noted that many members of the "old guard" with interests vested in the current system see change as a threat to their survival, further stunting economic and social development. The appointment of Sharifov as Minister of Finance, noted one participant to Senator Lugar, was an exception. Ambassador Derse commented that the lack of institutional capacity in the GOAJ and Azerbaijan was also holding back the country and economy. Woodward added that the lack of managerial capacity and reform at the State Oil Company, SOCAR, was hampering its efforts to become an international-caliber energy company.

¶10. (C) Lugar raised the idea of sending Azerbaijan's best and brightest to the U.S. or Europe for educational and vocational training. All the executives thought the idea was sound and noted that the GOAJ is contemplating such a plan. The executives noted that the major drawbacks to this idea, however, were the lack of meaningful employment opportunities in Azerbaijan and low government salaries to attract back these students. All the executives agreed on the need to reform the education system, citing rampant corruption, unqualified students and the growing brain drain of trained Azerbaijanis to other countries.

¶11. (C) The energy executives said that external pressure by the international community is needed to bring about real reform in Azerbaijan. One participant noted that since the arrival of the first petrodollars, some in the government have come to believe that there is no need for further reform and development. One executive noted that President Aliyev talks a good talk, but does not have the power to take on the vested political and economic interests in the country. The group returned to the theme of corruption and its negative effect on the country and economy. The executives noted that young people are becoming disillusioned and international companies are not investing in the country due to the negative effect of corruption.

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#### PSA SYSTEM AND NEED FOR REGIONAL COOPERATION

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¶12. (C) The energy executives briefed Senator Lugar on the Production Sharing Agreement framework regulating the energy sector and the benefits that it provided. The executives also touched on the tax system and the required contributions to Azerbaijan's pension system, the Social Protection Fund. One executive who also works in Kazakhstan noted to the group that the GOKZ was renegotiating PSA with international energy companies, removing some of the tax incentives. Woodward remarked that the GOAJ's interest in renegotiating PSA's was also growing. The group was unanimous in encouraging the GOAJ to increase the incentives for investment, including working with other Caspian countries, such as Kazakhstan, to maximize regional development. One remarked that Azerbaijan and Kazakhstan should sign a regional joint government agreement to share competitive advantages. Currently, laws and "local content" regulations in both Azerbaijan and Kazakhstan prohibit international companies from using base operations and construction projects in one country for use in the other.

#### NON-OIL SECTOR AND ENVIRONMENTAL ISSUES

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¶13. (C) Lugar turned the discussion towards the agriculture sector in Azerbaijan, noting that the U.S. would be able to provide assistance to strengthen the sector. Some of the participants thought that it may be "too early" for the GOAJ to turn away from its energy sector, growing oil wealth and efforts to accelerate modernization through infrastructure

projects. Lugar noted the terrible environmental cost that oil had reaped on Azerbaijan, leading one participant to comment that Azerbaijan had priorities other than cleaning up years of oil spills. Woodward said that the World Bank was studying a project that would begin cleaning certain areas of Baku, looking to leverage oil recovery and scrap metal collection as incentives to additional cleaning efforts.

¶14. (C) Lugar also raised the problem of potable water in Azerbaijan, noting that with a small population and large oil revenues the GOAJ needed to improve the lives of its citizens. He indicated that he would raise the importance of sustainable economic development with President Aliyev, adding that Azerbaijan does not appear to have an urban development plan and the GOAJ needs to implement a strategic economic development framework. The energy executives noted that the GOAJ did not always want international consultants to offer assistance and tended to look inward. The group noted that Azerbaijanis have a long oil history and that there is no comparison of the mentality and culture between Azerbaijan and Kazakhstan. Azerbaijan, according to the energy executives, was more likely to indicate that it knew what needed to be done, basing its misplaced confidence on its long history of working with oil.

#### **DOMESTIC AND REGIONAL STABILITY**

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¶15. (C) Noting the recent explosion of a gas pipeline in Turkey, Senator Lugar and the executive agreed on the need for regional political stability. During his April visit to the U.S., President Aliyev alluded to Azerbaijan's geographic location between Russia and Iran as a key reason for his country's interest in fostering good relations with the U.S. Lugar recounted his previous trips to Azerbaijan, noting how much had changed and how fast the country had developed. Calling it a "success story" with its oil and gas finally reaching international markets, the meeting participants noted that now is a critical period for reform and combating corruption. With the reform window slowing closing, Azerbaijan's success could quickly turn to a failed petrostate. Lugar noted to the group that one minister's efforts to reform the economy could influence other ministers to do so also.

¶16. (C) The energy executives noted that the 2010 parliamentary elections were more significant than the 2008 presidential elections since President Aliyev will "ensure" that he is reelected as president. Turning to Nagorno-Karabakh, the conflict with Armenia and its effect on the business climate, AIOC President Woodward noted that N-K

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does not directly factor into energy companies' business plans but that a military conflict would be a disaster. He added that BP has taken certain precautions with the BTC route and that in the case of military conflict BP would continue to operate in Azerbaijan.

¶17. (C) COMMENT: In other meetings with Chairman Lugar, both Economic Development Minister Heydar Babayev and President Aliyev described at length Azerbaijan's poverty reduction and economic and social development plans and ongoing projects (septel).

¶18. (U) Codel Lugar did not have an opportunity to clear this cable prior to departing post.

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